Chapter 10

Germany and the Euro

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The introduction of the common currency – the euro – in initially 11 member states of the EU was the biggest single step of supranational integration since the beginning of that process in the 1950s. While there were big hopes about the positive economic and political consequences of that step (ranging from reduced transaction costs and increased economic growth to benefits for European identity and a weightier role in global economic politics), sceptical voices could also be heard warning of reduced flexibility for national economic policy – especially in the cases of asymmetric shocks – and the dangers of a single monetary policy that might not be appropriate for the diverging needs of member states.

More than a decade after the euro was introduced – and in particular after the crisis within the eurozone in the years since 2010 – it has become clear that the success of the project is seriously in danger if no solution to the ongoing debt crisis of several eurozone member states can be found. It is now also evident that the consequences of the introduction of the common currency have been substantial for the states concerned, but that these consequences vary a lot depending on the country and time period taken into consideration. For the case of Germany, the chapter will explain in greater detail the mix of advantageous and disadvantageous effects that the introduction of the euro has brought.

The chapter begins with a brief discussion of the rationale and history of European monetary integration and then discusses the somewhat ambiguous relationship Germany has had with the common currency from its inception through negotiations to its eventual introduction, taking both international and domestic factors into account. The positive and negative economic consequences of the euro for Germany are then outlined, arguing that the latter outweighed the former over roughly the first five years of the new currency's lifetime, while since about 2005 the benefits have clearly won the upper hand in Germany. How Germany positioned itself during the crisis in the eurozone since 2010 will be the focus of the last part of the chapter.

Monetary integration in Europe: a brief primer

Giving up a sovereign currency and opting to join a common currency is a big decision for any country to take. The reasons many European countries had for this is essential background knowledge for understanding the topics discussed in this chapter. Some key economic and historical facts and motives that played a role in the creation of the euro are then outlined.

The roots of the common currency project date back at least until the early 1970s. Under the leadership of the then Luxembourg prime minister and minister of finance, Pierre Werner, a report was produced and presented in October 1970 which recommended the introduction of a common European currency. The plan suggested three stages and a schedule for its introduction. But the breakdown of the system of fixed exchange rates – better known as the system of Bretton Woods – in 1973 initially prevented the implementation of these plans. The shift from fixed to flexible exchange rates proved a sea change in global economic policy.

Contrary to expectations, this led to massively increased volatility (rather than more stability) between national currencies, which manifested itself in wildly fluctuating exchange rates, in turn impeding trade relations. In the years after 1973, an increased desire to achieve currency stability manifested itself within Europe. The main reason for this was the close economic interdependence between the member states of the European Community (as the EU was then called). Jointly (as the EU or the EC) these states have a degree of economic openness – measured as the sum of imports and exports as a percentage of GDP – that is roughly comparable to that of other big economic areas such as the United States or Japan; taken individually (as single states), however, they show a much higher degree of economic openness. This high degree results from the very close trade relations between the member states which has been historically one of the core goals of European economic integration. Strong fluctuations in the exchange rates between the national currencies were therefore detrimental to trade relations and had a negative economic impact.

In 1979, at the initiative of German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing, the European Monetary System (EMS) was introduced. This had the twofold aim of limiting exchange-rate volatility and exerting a disciplinary effect on economic policy by creating incentives that would let governments strive to avoid devaluation of their currency. A change in the dominant conception about the goals that economic policy was to achieve (from Keynesianism towards monetarism) added further to making disinflation a priority in the participating countries – and the result was an increase in macroeconomic discipline. The Keynesian idea of a significant and politically exploitable trade-off between unemployment and inflation (the 'Phillips curve') was given up in favour of a concept that saw low inflation as a precondition for economic growth and improved competitiveness. The EMS provided a mechanism to cope with the political and economic costs inherent in this new approach by allowing policy-makers to shift the blame for necessary adjustments to an international regime and thus avoid electoral punishment.

Even though there were occasional crises in the system (e.g. in 1992/93, see Busch, 1994) which prompted the temporary (and in some cases permanent) withdrawal of some member countries from the system, the substantial 'conversion to macroeconomic discipline' (Sandholtz, 1993) promoted by the EMS led to renewed debates about the introduction of a common European currency. These discussions eventually resulted in the calling of several intergovernmental conferences at the European level from which the concept of a common currency emerged – after laborious and highly complex negotiations which were due to the different preferences both between and within the participating nation states. Giving up their national currencies and handing over monetary policy to a supranational institution (the European Central Bank – ECB) was a massive step in terms of national sovereignty.

Initially 11 member states of the eurozone undertook this big and irreversible step towards further political and economic integration. They expected positive consequences to flow from this in two regards: first, for European citizens to increase their identification with the EU; second, for positive economic effects which would follow from increased efficiency and reduced transaction costs, such as a positive contribution to economic growth in all member states of the eurozone.

Germany and the euro

As Europe's biggest economy, the Federal Republic of Germany played a central role in these negotiations. The Deutschmark had established itself as the de facto anchor currency in Europe in the years after 1973 and particularly after the installation of the EMS in 1979. This was mainly due to the monetary policy pursued by the Bundesbank which focused above all on the goal of price stability. The German rate of inflation had consistently been one of the lowest in Europe, and the Deutschmark in international markets was considered a safe haven currency in terms of stability (Busch, 1994).

Why should Germany give up that dominant position, drop its successful currency and entrust its smoothly running economy to the uncertain prospect of a new currency, run at the supranational level? Looking at it from that perspective, it is quickly evident that for the Federal Republic to make that step was no easy task; and as the negotiations demonstrated, it required a number of concessions from Germany's European partners.

Conflicts about the common currency

As stated, interests regarding a common currency to replace the Deutschmark diverged. The federal government pushed for deeper European integration and was willing to use monetary integration as a tool to achieve that end. Foreign Minister Genscher pursued that strategy in the aftermath of the Single European Act, and he was supported by Chancellor Kohl. Both were willing to give up the Deutschmark if required. Kohl used the European summit in Hanover in June 1988 to establish a committee under Commission President Jacques Delors that was to study possible ways to EMU. Support for further integration on the German side also came from German industry which was keen to create more stable conditions for its export markets in Europe. In terms of economic theory, this was a position that expected European economic integration to be actively enhanced by a common currency, using it thus as an instrument in that process.

But there were also powerful opponents, or at least sceptics, with regard to the goal of further monetary integration. The most important of them was the country's powerful central bank, the Bundesbank, which was largely independent in its conduct of affairs, but afraid that it might lose its influence (and maybe even its existence) if the currency that it produced and regulated were to dissolve into a common European currency. Scepticism and often outright hostility towards the goal of monetary integration was also pronounced by many academic economists in Germany. Their argument was that the potential member states for a common currency were still much too different in their economic structures for a monetary union to succeed. But a single currency, they argued, could only be successful once substantial further economic convergence had taken place.

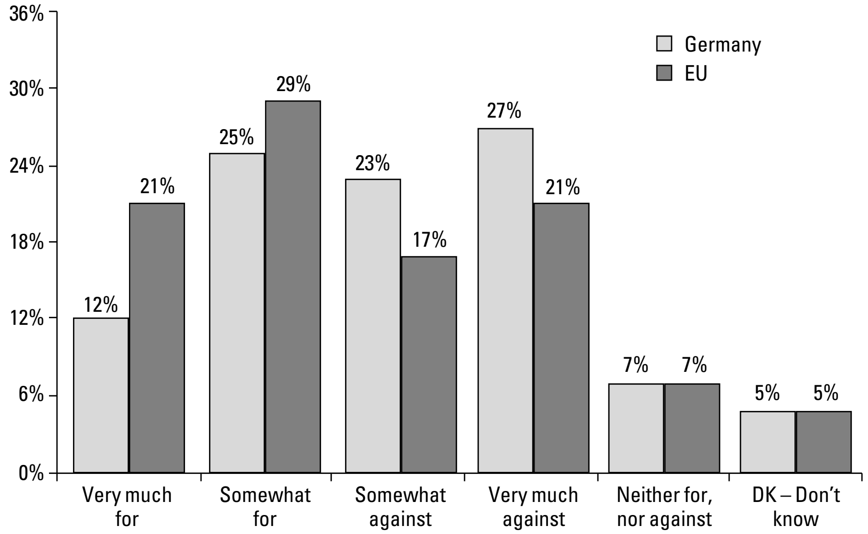
Negotiations in the Intergovernmental Conferences that officially opened in Rome in December 1990 were highly complex and took considerable time (Dyson and Featherstone, 1999). For the German government, the collapse of the Berlin Wall and German unification were further motives to proceed speedily with European integration in order to assure its European partners of Germany's ongoing commitment to that process. This made it even more difficult for the Bundesbank to voice its opposition – in spite of its independence, it could not openly contradict the federal government in international negotiations and thus chose – using its economic expertise – to put forward demands that an eventual solution would have to meet. mong them was the acceptance of price stability as the overriding goal in monetary policy as well as the safeguarding of the central bank's independence.

Support for the concept of a strongly independent central bank eventually emerged from the discussions and was enshrined in the text of the Maastricht Treaty. Its Article 105 states the primary objective of the ECB is 'to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2'. And Article 107 declared that 'neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body'. The concrete regulations concerning the appointment and dismissal regulations for members of the Governing Council of the ECB were designed to provide the underpinnings for that independence by giving them long terms in office (eight years) but which were not renewable so as to avoid behaviour designed to win a second term.

These rules were even harsher in terms of securing council members' independence than those of the Bundesbank had been (where terms could be renewed). But they were undoubtedly inspired by the construction of the German central bank which served as a blueprint for much of the institutional set-up, not least because a combination of two levels (that of the central institution plus that of the constituent countries' central banks) was necessary, as in the German federal system. Situating the new ECB (and its precursor, the European Monetary Institute) in Frankfurt was a move intended to reassure Germans that nothing really would change. To them the message was that the new ECB was really the Bundesbank, but transplanted onto the European level and taking care officially of tasks that it had previously fulfilled unofficially, namely running Europe's monetary policy. Nothing had changed, so there was nothing to fear – the euro really was the Deutschmark in disguise.

But the planned new currency was not very popular in Germany. Opinion polls showed that – compared to other EU countries – Germans were far more sceptical of replacing their existing national currency with a new European one (see Figure 10.1), a position that changed little as the date of the planned introduction drew nearer. While not quite on the level of opposition found among the British population, Germans found little support for their scepticism among the established political parties.

Figure 10.1 *Support for the single currency in Germany and the EU*



Source: European Commission (1998).

The government of Chancellor Kohl supported currency union for reasons of both economic and foreign policy – it was keen to send a clear signal of Germany's future commitment to European integration after German unification. Traditionally in favour of integration, all parties in the Bundestag supported the goal of a single currency. But at the level of the *Länder*, some politicians experimented with (sometimes coded) positions opposing currency union; they had, however, little electoral success. In 1992, the leader of the Baden-Württemberg SPD, Dieter Spöri, for example argued that the introduction of the common currency was too early and would endanger German jobs, because only a few countries would qualify while the others would devalue. In 1998, the then SPD Chancellor Candidate Gerhard Schröder called the euro an 'ailing preterm delivery' ('*kränkelnde Frühgeburt*'). And in 1994, former FDP politician Manfred Brunner tried to focus opposition to the new currency by founding a party called the Federation of Free Citizens (Bund freier Bürger), which, however, only polled 1.1 per cent at the European Parliament election and 0.2 per cent at the 1998 Bundestag election. Other small right-wing populist parties such as Initiative Pro D-Mark had a similar fate. The scepticism present in opinion polls, to sum it up, did not translate into political mobilization, and since the Federal Constitutional Court also did not stop the project in its 1993 ruling on the Maastricht Treaty, the new currency became a fact in 1999.

The German experience with the euro since 1999

What were the consequences for Germany of dropping its own successful currency, the Deutschmark, and introducing the new supranational euro? This question is of central importance, yet there is no simple answer to it. Rather, as will become evident in the following, the introduction of the new currency has had a variety of effects on the German economy. In addition, the overall effect has varied over time: while initially the disadvantages were dominant, in the years since 2005 the positive effects have prevailed.

Negative consequences

Support for the introduction of the euro had been almost uniform among political forces in the Federal Republic. The expected positive consequences, however, initially did not materialize. In the years between 1999 (when the euro was introduced as virtual money, with notes and coins only following in 2002) and 2005, Germany's economy was characterized by persistent and high unemployment and a performance, in terms of economic growth, that was consistently below that of the other eurozone countries – often more than 1 percentage point (see Table 10.1).

The bad economic performance profile that characterized Germany early in the first decade of the century was to some extent caused by disadvantageous effects that the introduction of the common currency had. These disadvantages were primarily indirect and often worked through effects on other member states of the eurozone. Above all two channels played a role: the loss of relative advantages that Germany had enjoyed in the level of interest rates; and a disadvantage due to the real interest rate effect under a single monetary policy. Let us consider both in turn.

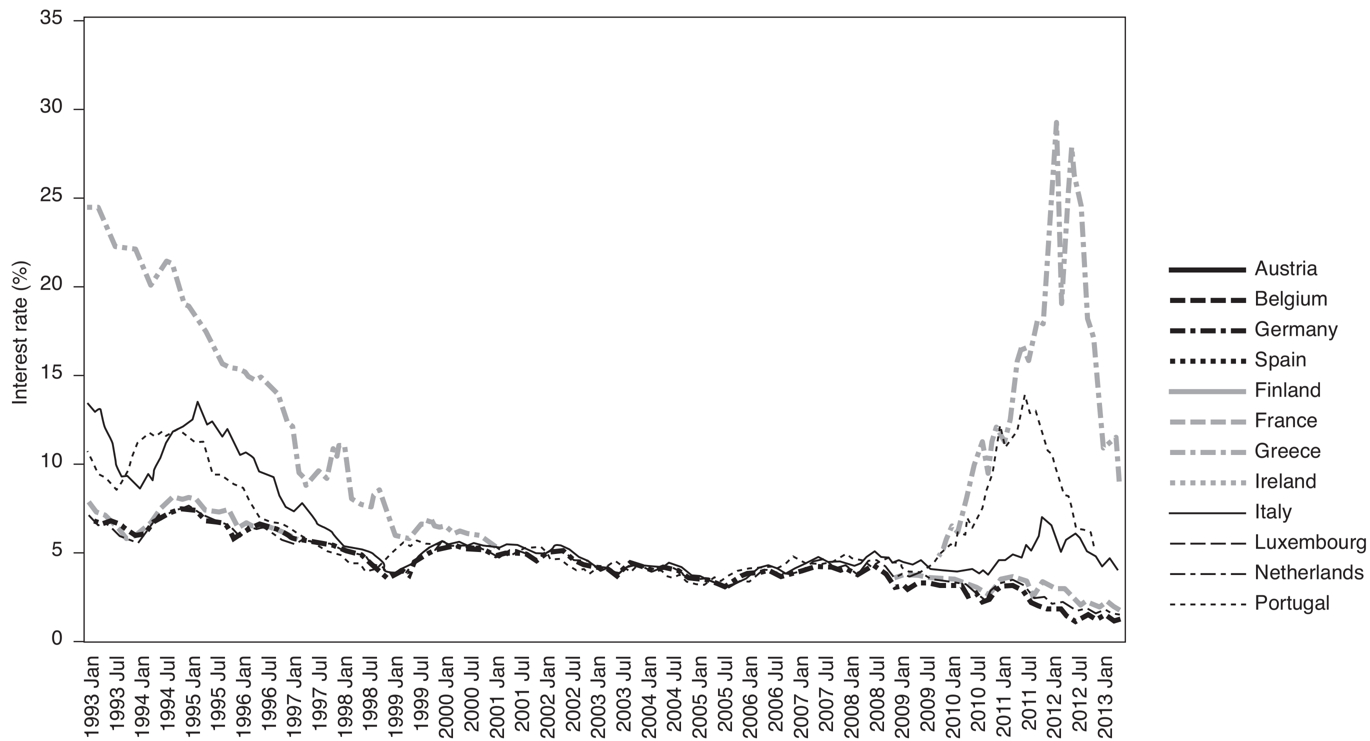
Germany, as the European country with the lowest rate of inflation and hence the most stable exchange rate, had always enjoyed a particularly low level of interest rates compared with that of other European countries. This was an advantage since German firms could obtain money in financial markets at a cheaper rate. That advantage, however, began to dwindle during the 1990s in line with rising expectations about the introduction of the common currency. The (first expected, then realized) creation of the currency union plus the constitution of the ECB focusing on price stability meant that other states would be able to import the credibility of monetary policy regarding future low inflation that had so far only been enjoyed by Germany. This meant that interest rates for government bonds of EMU member states began to close in on those issued by Germany as the interest rate advantage of the German capital market began to disappear (see Figure 10.2).

Table 10.1 *Annual economic growth rates, 1999–2013 (%)*

	1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Eurozone without Germany	4.2	4.6	2.1	1.7	1.2	2.8	2.7	3.7	4.0	0.9	–4.3	1.4	1.2	–0.7	–0.8
Germany	2.0	3.2	1.2	0.0	–0.2	1.2	0.7	3.7	3.3	1.1	–5.1	4.2	3.0	0.7	0.4

Source: Author's calculations; Eurostat database (© European Union 1995–2014).

Figure 10.2 *Comparison of interest rates on ten-year government bonds, 1993–2012*



Source: European Central Bank.

Lower interest rates created an expansionary effect that was the stronger, the bigger the initial difference over the German level of interest rates had been. All countries enjoyed that effect – except the Federal Republic – and this had to have a negative effect on comparative economic growth; so German growth rates started to lag behind those of most other EMU countries.

A further effect working in a similar direction resulted from the fact that monetary policy in a currency area can only set a single level of interest; yet inflation rates between member states of the eurozone may differ considerably in spite of all attempts to achieve convergence. In economic analysis, this is acknowledged in discussions about 'optimum currency areas'. National rates of inflation can vary even though all EMU countries have the same currency. But the ECB cannot take specific national circumstances into consideration: its task is to steer the best monetary policy course for the whole of the eurozone. The more national rates of inflation differ, the more likely it is that ECB policy will be less than optimal for some countries, because it is either too expansionary or too restrictive for them. But the central bank can only determine the nominal interest rate; the effective real rate of interest is dependent on the rate of inflation in a given country, which – as we have seen above – may vary.

Particularly at the beginning of the common currency, rates of inflation differed considerably across countries in the eurozone, and this resulted in substantial differences in real interest rates. Countries enjoying already relatively robust rates of economic growth usually displayed a higher rate of inflation than Germany which traditionally enjoyed a culture of price stability (Busch, 1995). The result was somewhat paradoxical: real interest rates were *lower* in those countries of the eurozone which had *higher* rates of inflation (and thus actually in need of a more restrictive monetary policy); and they were relatively *higher* in countries enjoying a *lower* rate of inflation – which needed a more expansionary monetary policy to stimulate their weak economic growth performance (as in Germany). Table 10.2 illustrates this effect for the year 2000 for selected countries. It

Table 10.2 *Real interest rates and inflation rates in comparison, 2000 (%)*

	Germany	*France*	*Ireland*	*Spain*
Rate of inflation	1.4	1.8	5.3	3.5
Real interest rate	1.35	0.95	–2.55	–0.75

Source: Author's calculations; IMF *World Economic Outlook* database.

demonstrates that Germany, with lagging growth, had the highest real rate of interest, while rapidly expanding Ireland and Spain (with their high rates of inflation) even enjoyed negative real interest rates.

Positive consequences

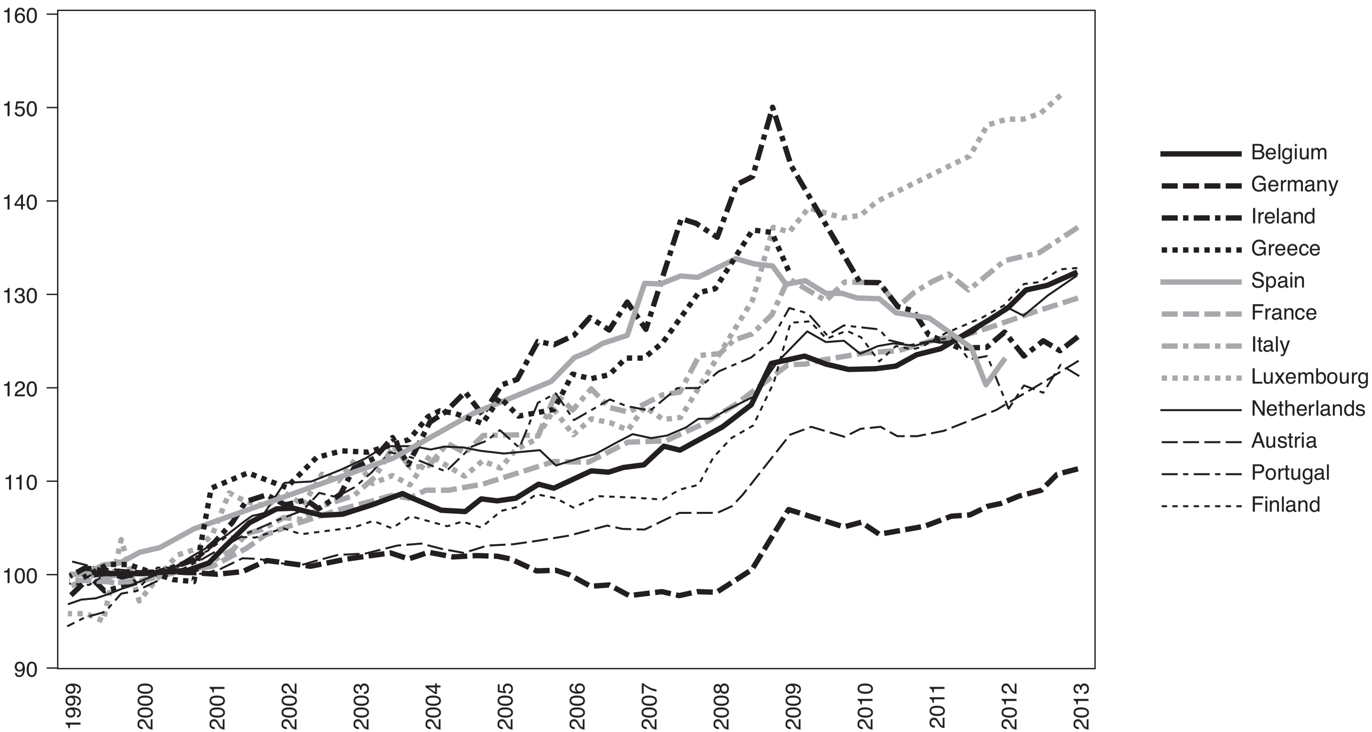
The dismal economic growth performance, as well as consistently rising rates of unemployment, over a number of years led to soul-searching and long debates in Germany about an insufficient economic performance profile and possible ways out of the performance trap. A flood of publications appeared bemoaning the apparently inevitable 'decline' of Germany, and it probably contributed as much to the pervasive feeling of hopelessness as did the negative performance indicators themselves. Germans felt miserable about the 'backlog of reforms', about an allegedly excessive wage level and the lack of competitiveness in global markets (Sinn, 2003).

It is hard to see how the situation back then – which some likened to a collective national depression – could manifest the motivation to try to change things. Yet the SPD–Green government under Chancellor Schröder, after it had unexpectedly won the Bundestag election of 2002, initiated substantial political reforms in the areas of labour market policy and social security systems. This 'Agenda 2010' more or less confirmed that the government had failed in its initial strategy to form an 'Alliance for Jobs, Innovation, and Justice' – the cooperation of the government with trade unions and employers – to combat unemployment and encourage growth, and that it now had to pursue an alternative strategy with a focus on increasing flexibility in the labour markets (Busch, 2009).

These reforms were (and remain) politically highly contentious, but – through interaction with Germany's traditional tendency towards price stability, achieved through the institutional characteristics of the system of collective bargaining which help contain inflation by keeping wage rises moderate under conditions of low economic growth – they contributed to an improvement of economic development and a recurrence of economic growth. From about 2005 onwards, the effects that the common European currency had on the German economy began to shift, and the euro started to turn into an economic advantage for Germany. Germany had managed – contrary to its more quickly growing Eurozone partners – to keep unit labour costs largely stable; many of the other countries, however, had seen wages rise quickly during their economic upswing, and far surpass increases in productivity. Unit labour costs had risen steeply as a consequence, as can be seen in Figure 10.3.

Differences in unit labour cost development mean differences in economic competitiveness, and the German economy thus began to profit

Figure 10.3 *Unit labour costs in comparison, 1999–2013*



Source: Eurostat.

Note: Labour cost 100 = year 2000.

from its improvement in competitiveness. This first resulted in rising exports, but from the middle of the decade onwards also in substantially increasing rates of growth of GDP.

The common currency which had produced on balance more negative effects for Germany in the early years now turned into a benefit for the country's economy. This worked above all through two mechanisms. First, the common currency denied other eurozone countries the option of compensating for their shrunken competitiveness by devaluing their currency (a devaluation reduces the price of domestic goods in foreign currency and thus increases sales). In the past, devaluation had often been a solution that in particular had been pursued by Southern European countries to cope with problems of a mismatch between wage development and productivity development. But this option was no longer available – correcting a negative competitive development was now only possible through either cutting wages or substantially increasing productivity. The comparative advantages Germany enjoyed in the area of unit labour costs stability could no longer be neutralized through unilateral action.

The second way in which the common currency in recent years has turned out to be a clear advantage for the Federal Republic, and thus a clear plus over the Deutschmark, has to do with uncertainty. In the past, investors seeking safety for their money tended to flee into the currency perceived as the most stable one in Europe, namely the Deutschmark. In the early 1990s, for example, the Deutschmark with its comparatively high stability had been chosen as a 'safe haven' by international investors seeking to preserve the value of their capital. That inflow of capital then resulted in an increasing exchange rate of the Deutschmark which in turn made German goods more expensive abroad, leading to reduced sales and resulting in declining economic growth and loss of employment. With the creation of the euro (and the demise of the Deutschmark), that option was no longer available. In the crisis that began in 2007, Germany therefore enjoyed (*ceteris paribus*) higher growth and lower unemployment than would have been the case without the common currency – a clear advantage.

The eurocrisis after 2010

Partly as a consequence of the financial markets crisis of 2007/08 and the ensuing 'great recession', the eurozone was plunged into grave problems in the years after 2010. At the time of writing, this crisis is not yet resolved, and no definitive assessment is therefore possible. In this section, however, the origins and manifestations of the crisis as well as the reactions to it (with a special emphasis on the German position) will be described and analysed.

On the tenth anniversary of the euro's introduction, in early 2009, there had been a lot of praise regarding the currency's performance (e.g. European Commission, 2008b; Verdun, 2010). The new currency was well established, it had held its value against the US dollar and inflation performance had been excellent. The economic downturn that had followed the financial markets crisis had been weathered well, and the fact that the eurozone was no 'optimal currency area' in economic terms – of which much had been made by the sceptics in the 1990s – had seemed to matter little.

But not long after, a crisis seemed to throw the success of the whole project into doubt. In November 2009, the new Greek government under Prime Minister Papandreou had revised the deficit statistics of their predecessors and discovered that the deficit was expected to be 12.7 per cent in 2009, more than double the previous estimate (Zahariadis, 2013). Since the country's national debt was already substantial (around 110 per cent of GDP), a crisis of confidence ensued as investors doubted whether the country would be able to service and pay back its debts and feared that the situation had become unsustainable. This in turn led to a massive rise in borrowing costs in international bond markets for the Greek government – which further tightened the situation for a country in acute need of rolling over its debt. Quickly the interest rates required were double those for Germany, and rising further. Over the next five years, Greece would need US$240 billion to pay for interest and principal (Marsh, 2011: 248).

As Greece faced a default on its debts, its partners were put into a difficult situation. The Maastricht Treaty which established EMU contained an explicit 'no bail-out' clause which ruled out direct financial help for the budget of any member state in the monetary union. Under the leadership of Chancellor Merkel and President Sarkozy, Greece's European partners therefore initially expressed political support, but insisted that the country had to reduce its deficit to become creditworthy again. When the markets displayed serious signs of uncertainty in early May 2010, however, EU finance ministers agreed on a rescue package of up to €80 billion in loans in a crisis meeting – after the Greek parliament, amid heavy protests and strikes, had passed a package of cuts amounting to 11 per cent of GDP over four years. Had there not been this reaction, it was feared that other economically and fiscally weak eurozone countries (like Portugal, Ireland and perhaps even Spain and Italy) might come under speculative attack in the financial markets; furthermore, debates about Greece eventually leaving the eurozone had prompted doubts about the currency union's future viability that could have negative consequences for all member states.

Feverish activity on the financial markets ensued in spite of these decisions. Its most visible consequence was the reversal of a trend that had characterized the process towards monetary union from the mid-1990s onwards, namely the convergence of interest rates. The 'spreads' (differences in interest rates) that markets demanded to hold government debt of different EMU member states were now rising for the first time in 15 years, and they did so most steeply for the countries hit hardest by the crisis, such as Greece, Portugal and Ireland (see Figure 10.2). Only a week after the decision about the aid package for Greece, over a hectic weekend, EU leaders agreed to combine fiscal and monetary policy measures on an unprecedented scale to stabilize the situation. Afraid that a Greek insolvency could cause turmoil similar to that of Lehman Brothers in 2008, the EU put forward €750 billion in loan guarantees while the ECB announced a bond buying programme of both government and private assets in an attempt to provide markets with liquidity. The European Financial Stability Facility (EFSF), as it came to be known, was an attempt to defuse the crisis and was a considerable step towards acknowledging a common responsibility for the fate of the common currency (Ludlow, 2010).

EMU member states were now paying the price for the decision not to complement monetary union with sufficiently stable rules for fiscal convergence or integration. The Stability and Growth Pact had proved toothless – between 1999 and 2009, the frequent breaches of the deficit criterion by member states such as Greece and Italy, but also France, Germany and Portugal, had had no serious consequences. The attempt, however, to make those rules more restrictive in an acute crisis amounted to an attempt to rebuild a ship in the open sea.

The principle of the EFSF deal (loan guarantees only in exchange for structural reforms; tighter formal rules for EU and/or EMU member states) became the role model for several rounds of crisis negotiations that ensued over the following months and years. The temporary EFSF was replaced by the permanent European Stability Mechanism (ESM) in 2011: the 'Pact for the euro' contained measures to increase member states' competitiveness; and the 'European Fiscal Compact' drastically tightened the fiscal rules for national budgets (including a mandatory embedding of these rules in national statutory or constitutional law), introduced automatic sanctions, and empowered the Commission to set targets for individual countries.

Economic conditions in many countries were dire: unemployment had risen steeply, growth was absent or negative, and the macroeconomic imbalances within the eurozone that had built up over the previous decade now lay bare. With all eyes set on the eurozone as a whole, nobody had cared much about trade imbalances between member states. But it was now clear that they were significant: many countries north of the Alps had persistent substantial current account surpluses, while many of those south of the Alps had equally persistent deficits. An expansion of domestic demand, fuelled by capital inflows (and the credit boom during the first decade of the common currency), had considerably damaged the Southern countries' competitiveness; and when the capital flows stopped after the onset of the financial markets crisis, much economic activity stopped (Gros, 2012).

The eurozone was thus split into two groups – the haves and the have-nots – turning the economic crisis into a political balancing act with substantial consequences for the EU. As the measures demanded by the IMF and the EU (in return for loan guarantees and emergency liquidity for banks from the ECB) began to bite, controversy and political protest flared up across Europe. Protesters in Greece, Portugal and Spain complained about the austerity imposed by a dominating North, while citizens in countries like Germany, the Netherlands and Finland feared for their money and saw Southerners as ungrateful recipients of their solidarity. It became clear that the technocratic approach to solving the crisis (through tightened rules, increased consultation, 'six-pack' legislation, the introduction of a 'macroeconomic imbalance procedure', visitations by the 'troika', etc.) did not easily coexist with the dynamics of electoral contest in the crisis countries, where parties were tempted to increase their electoral chances by promising to renegotiate the results of ongoing consultations, thus casting doubts on the validity of the results even before they were achieved. Also, as national governments were the ones to sign the loan guarantees, they became the dominant players in the handling of the crisis, sidelining EU institutions like the Commission.

Analysing the German response

As the biggest EU economy, Germany was a crucial player in the discussions about the handling and resolution of the crisis. No longer the 'sick man of Europe' it had been a decade earlier – since 2006, German economic growth routinely met or surpassed that of the eurozone as a whole, see Table 10.1 – the Federal Republic eventually guaranteed more than €200 billion which (at the time of writing) have been used as loans to Greece, Ireland and Portugal.

But Chancellor Merkel's handling of the crisis has also received a lot of criticism, both abroad (where likenesses of her were adorned with swastikas and Hitler moustaches, indicating a continuity between Nazi occupation and German financial dominance today) and at home (where considerable disquiet and the emergence of an anti-Euro party were the most visible signs of protest). In this section we will therefore analyse the reasons for the German government's behaviour in the euro crisis.

The German perspective on the causes of the crisis, most notably in Greece, was influenced by its own position. Germany had handled the 'great recession' well and it was clear from the beginning that the country would have to play a major role in the resolution of the crisis. Given the obvious problems of mismanagement, corruption and fiscal profligacy in Greece (Zahariadis, 2013), German political discourse quickly settled on excessive spending as the root cause. When other countries (like Ireland and Spain) also got into trouble, the fact that they did so for quite different reasons (the state bail-out of an oversized banking sector in the case of Ireland, and the collapse of an excessive construction sector in the case of Spain) was conveniently ignored by the German political class. A one-size-fits-all solution was advocated, namely a reduction in public spending and a cutting of deficits. The fact that in German, the words for 'debt' and 'guilt' are the same (*Schuld*) has often been remarked upon, because it gave the discussions moral overtones. Under the German concept, the burden of adjustment would mainly fall on the deficit countries, and differences between them ignored.

Focusing on cutting deficits fitted well with two other important facts, namely the dominance of ordoliberal economic thinking and the interpretation of Germany's own recent experiences. Contrary to many other Western countries, Keynesian economic thinking – with its emphasis on the short term and an active role for state-sponsored reflation during a recession – had never been really influential in Germany except for a brief period between the mid-1960s and the mid-1970s (Allen, 1989). Instead, the emphasis was on the medium to long term and the significance of the right incentives for economic behaviour to be set by well-ordered institutions (Nicholls, 2000). For most Germans, the period of painful reforms in the labour market and the social security system that the country had undergone in the early years of the new century (Agenda 2010) were proof of the correctness of these assumptions. If Germans had managed to extricate themselves from years of economic depression through painful reforms (which included low rises in real wages and a stagnation in living standards for a decade), surely others could follow in the same way. Chancellor Merkel summarized this approach before the Bundestag in her declaration of government on 19 May 2010 after the EFSF decision:

> Too many uncompetitive members of the eurozone have lived beyond their means and have thus found the way into the debt trap. This is the real cause of the problem. Therefore we have to tackle the root of the problem. At my suggestion, on 7 May 2010 the heads of states and

> governments have committed themselves to speed up within the stability pact the consolidation of their respective budgets. (Merkel, 2010)

This approach met heavy criticism from many sides. Only a week later, on 26 May 2010, the *New York Times*, in an editorial entitled 'Germany vs Europe', accused the German government of responding irresponsibly to the economic malaise:

> Instead of committing to more spending, Germany is now preparing a multiyear program of deep spending cuts. Given its troubled history, we can understand its fear of deficit spending and inflation. But right now more German austerity will likely cripple Europe's nascent recovery and Germany's own prosperity.

Criticism was also put forward by political scientists arguing that the rescue efforts for the euro were ill-suited to correct the economic imbalances within EMU while threatening to cause a crisis of democratic legitimacy (Scharpf, 2011). And economists have pointed out that – both in the UK and the eurozone – in retrospect one has to say that 'austerity has failed' (Wolf, 2013). At least for the eurozone, the argument goes, this need not have happened, as Germany enjoyed windfall profits from the crisis (in the shape of very low interest rates payable on German public debt) that the country could have shared with those under pressure (ibid.).

To understand why Chancellor Merkel chose such a demanding position one has to take into account the domestic restrictions she faced to find support for any rescue packages she would commit to in return for structural adjustment ('solidity for solidarity', as it was put). Given the nature of Germany's 'semi-sovereign state' (Green and Paterson, 2005b), a number of countervailing forces had to be taken into account:

- The Bundesbank had immediately formally registered its opposition to the bond buying programme when the ECB announced it as part of the EFSF. This had no practical consequences, since the Bundesbank operates as part of the ECB and is bound by its decisions; but it did register in German public discourse. The Bundesbank also continued to support (through speeches of their board members and publications) the position that structural reforms in the weaker countries were the best way to attain a macroeconomic rebalancing. In February 2011, Bundesbank President Axel Weber announced his resignation, to be followed in September by ECB chief economist and board member Jürgen Stark. Even if it was not formally stated, it was clear that both men saw the ECB decision as a watershed that amounted to state funding through monetary policy, which had been ruled out in the Maastricht Treaty. While both through their withdrawal further weakened the orthodox position in the central bank's decision making bodies, they encouraged dissenters in the Bundestag to voice their criticisms openly. Weber's successor, Jens Weidmann, who had been Merkel's chief economic advisor, seamlessly continued the Bundesbank's traditional position by arguing (in a speech at Chatham House on 28 March 2012) that 'the risks of consolidation are consequently being exaggerated' (Weidmann, 2012).

- In Chancellor Merkel's coalition questions emerged about the money Germany (as the biggest contributor) would have to put forward. In December 2011, a ballot of FDP members which had been initiated by opponents of the European rescue programmes was only very narrowly defeated by the leadership. While an overall majority in parliament was never in question due to the Social Democrats' and the Greens' support for the measures – in line with their traditionally pro-European position – the coalition repeatedly had to make substantial efforts to ensure a parliamentary majority, which was politically important for the chancellor.
- Outside parliament there were attempts to harness the clear public discontent with the measures taken and direct it into support for a new political party. In February 2013, Alternative for Deutschland (AfD) was formed with the core political programme of an 'orderly dissolution of the euro currency area'. Among the initiators were a number of academic economists, though no prominent dissenters from existing parties. Organizing the new party as well as agreeing on the remainder of the party's political programme proved difficult. At the general election on 22 September, the party at 4.7 per cent of the vote missed the 5 per cent hurdle required for entry to the Bundestag, but only narrowly.
- A last obstacle that influenced the chancellor's strategy in the euro crisis was fear of the Federal Constitutional Court. EMU and all steps towards further European integration had been challenged before the Karlsruhe court, and any measures for crisis resolution that would include German public money was sure to end up there as well. Demands for temporary orders (by a strange coalition of dissenting CSU MP Gauweiler, the association for 'More Democracy' and the Left Party) to stop the entering into force of the ESM and the Fiscal Pact were denied by the Court in July 2012. On 7 February 2014, the Court – while making clear its doubts whether the ECB had remained within its mandate in its September 2012 decision to enter into 'outright monetary transactions' of a potentially unlimited volume – decided to refer the case to the European Court of Justice for a preliminary ruling. This is a first, and it will delay the eventual decision for

some time. If the FCC were to declare parts of the ESM as unconstitutional, this could throw a major spanner into the rescue works of EMU.

The above can also explain why Chancellor Merkel comprehensively ruled out eurobonds at an early stage, although many different variations of such bonds can be imagined (with varying degrees of common debt guarantee between EMU member states) along with several clearly positive consequences that the establishment of a large and deep common market in European government bonds would bring. As the CDU put it in its 2013 general election manifesto, the introduction of eurobonds 'would mean introducing a European debt union in which German tax payers would have to assume almost unlimited guarantees for the debts of other countries. That we oppose' (CDU/CSU, 2013: 9). This, the document goes on, would forfeit the 'quid pro quo' principle and would undermine incentives for EMU member states to undertake 'uncomfortable reform efforts'. The FDP, too, was opposed to communalizing liabilities for past debts and emphasized the importance of further structural reforms. The SPD, however, indicated in its programme that, after agreement on the fiscal pact and other European level control mechanisms pushing towards national budgetary discipline had been reached, 'the issue of common liability must no longer be taboo' (SPD, 2013: 105). It also pointed out that a European level debt resolution fund of all EMU member states 'could be an instrument against financial speculation'. The Greens were even more open, demanding a European Pact for Debt Redemption and the transformation of the ESM into a European Monetary Fund as well as the introduction of eurobonds in the future, while also pointing out the necessity of budgetary consolidation (Bündnis 90/Die Grünen, 2013: 57).

To conclude the assessment of Germany's role in the euro crisis so far, one has to say that the picture looks more differentiated than the widespread perception of Angela Merkel as the dominant player would have it. Germany at an early stage (in spring 2010) managed to push the European level crisis response in its preferred direction, insisting on clear conditions and structural reforms in exchange for limited financial help. Later measures, like the Pact for the Euro, the ESM and the Fiscal Pact, built on that decision and followed substantially on the path initially chosen. But the unquestioned dominance of Germany in this respect needs two qualifications. First, agreeing to intervene 'if the financial stability of the euro area as a whole was at stake was in and of itself a major break with both the letter and the spirit of the Treaty' (Ludlow, 2010: 49) – so that policy constituted a U-turn and certainly was not Germany's first preference, which hence questioned its dominance. Second, German domination was limited to the fiscal policy dimension of the crisis response – on the monetary policy dimension several key decisions (such as those to engage in government bond purchases) went against German preferences. Of course one can speculate as to what extent the orthodox position taken by the once almighty Bundesbank really coincided with the preferences of Chancellor Merkel – or whether this was part of a game of playing to the gallery. Surely Axel Weber's withdrawal was ultimately a fortunate move – it is as difficult to imagine Germany dropping support for him as ECB president as it is certain that debates with him at the central bank's helm would have made debates and a functioning division of labour between fiscal and monetary policy far more difficult than was the case under Mario Draghi.

Conclusion

The introduction of the euro has been a supremely important step in the history of all EMU member states, and for none more so than Germany. Having reflexively opted for pro-European and multilateral policy options in the past, Germany was among the political forces pushing for a common currency in the 1980s. Even if there were clearly divergent preferences within the country and little excitement in its population to give up the treasured Deutschmark (the symbol of the country's re-emergence and economic success in the decades after the Second World War), economic and political interests ultimately weighed in favour of adopting a common currency. All attempts to mobilize political support against this had failed in the 1990s.

Germany had managed to extract substantial concessions in the design of the EMU and especially its institutions in exchange for its willingness to give up the Deutschmark. The currency established itself well in global markets, and was welcomed by many as a challenger to the US dollar. Even the biggest crisis for economic policy since the 1930s, the financial markets crisis of 2007/09 that turned into a global great recession, was handled well by the eurozone, as assessments on the occasion of the currency's first decade declared (European Commission, 2008b). But already in these assessments there were premonitions that the divergence of the fiscal stance among member countries would need to be corrected. It then became very evident with the crisis in the eurozone that developed after 2009 that the institutional mechanisms governing EMU had substantial shortcomings and had to be fundamentally reformed.

As the economically dominant country, Germany had to play a key role in the resolution of this crisis. In an echo of past reflexive multilateralism, German politicians across the spectrum emphasized that the answer to the crisis had to lie in more – not less – integration, in 'more Europe' (as

Finance Minister Schäuble put it in an article in *Welt am Sonntag* on 2 October 2011). If sometimes through gritted teeth, the political class thus reacted with continuity and support for past decisions. Given the 'sunk costs' of European integration this is not really surprising. But Germany, having been aptly described as a 'reluctant hegemon' (Paterson, 2011), could not provide a resolution and was criticized for that. At the same time, the country was also criticized for dominating the austerity policies that were (as some saw it) causing economic depression in Greece and elsewhere. While the broader context for Germany's European policy is described in chapter 12, in the perspective covered here the absence of European-level tools at the beginning of the crisis and the specific domestic obstacles faced by Chancellor Merkel have been emphasized to explain developments.

Within Germany, insecurity about the future of the euro and disenchantment with the common currency was evident during the crisis. Opinion polls repeatedly demonstrated this: in September 2011, for example, according to Politbarometer (Forschungsgruppe Wahlen, 2011) only 19 per cent supported the extension of the German contribution to the ESFS from €123 billion to €211 billion, while 75 per cent opposed it – across all parties. And only 46 per cent at that point thought that overall the euro was advantageous for Germany, while 50 per cent thought the single currency overall disadvantageous. The higher the educational achievement of individuals, however, the higher the perception of advantage: among those with *Abitur* and university education, euro supporters continued to have a clear majority. Yet all this doubt had little political effect. Although 2013 saw a general election campaign, the euro did not feature prominently in it. The parties in the Bundestag had overwhelmingly supported the rescue strategy of the chancellor and the EU; but none of them saw a debate about it as an election winner, and so none had much of an interest in pushing it. The AfD's failure to make it into the Bundestag proved that strategy right for the established parties.

As this volume goes to press, the new grand coalition that is the result of the general election of 2013 is still largely untested. Although the CDU/CSU won decisively and Chancellor Merkel is in her third term in office, this means that a policy shift to the left of the previous government will take place – one of the paradoxes of an election outcome which saw the demise of the FDP after almost 65 years in the Bundestag. In terms of future policy on the euro, this opens up some room for manoeuvre, as both potential coalition partners are more open about innovations regarding fiscal policy and eurobonds, as described above. The CDU, in which Angela Merkel is presently at the apogee of her power, would doubtlessly stomach another of her policy U-turns were she to decide that was necessary. However, this is unlikely to affect central areas of her previous policy stance. But compromises regarding the speed of budget consolidation, the amount of financial support put forward or even a cautious version of common bond issues are more likely now that she no longer has a coalition partner who is threatened by Eurosceptic leanings of its membership and electorate (as the FDP was). On banking union (at least as far as a common resolution mechanism is concerned) a softening of the present German stance seems possible, especially since the legal arguments put forward so far against a common resolution fund are weak.

Today, it is difficult to assess whether EMU member states will succeed in fixing the initial faults that have bedevilled the eurozone in recent years, or whether 'a heinous inversion of good but poorly implemented intentions' (Marsh, 2011: 265) will lead EMU to fail. If it were to, the outcome would certainly be regarded as catastrophic by most German policymakers. They will therefore likely do their utmost to avoid.